

## **THE INDUSTRIAL INSURED IN ILLINOIS: TAX CONSEQUENCES - ARE THERE ANY?**

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There has been some confusion in the insurance industry as to what tax consequences, if any, occur in an industrial insured transaction and who is responsible for those taxes. This article explains the industrial insured transaction under Illinois law and to whom the burden of relevant taxes fall.

### **An Industrial Insured May Transact Business with Unauthorized Insurers**

The industrial insured provision of the Illinois Insurance Code permits an industrial insured to procure insurance from an insurer that does not hold a certificate of authority in Illinois. The general rule is that an insurer may not transact insurance business in Illinois without obtaining a certificate of authority issued by the Director of Insurance. Section 121-21 of the Illinois Insurance Code permits ten exceptions to the general rule. The section states, "Transacting business without a certificate of authority prohibited - Exempt transactions. It is unlawful for any insurer to transact insurance business in this State, (as described in Section 121-3,) without a certificate of authority from the Director. This Section does not however, apply to any transaction described in Sections 121-2.01 through 121-2.10."

The exemptions cited in the section are,

- § 121-2.01 Surplus line transactions under license.
- § 121-2.02 Reinsurance transaction.
- § 121-2.03 Policies solicited outside of Illinois.
- § 121-2.04 Attorneys acting in adjustment of claims or losses.
- § 121-2.05 Group insurance policies issued and delivered in another state.
- § 121-2.06 Policies or annuities issued before 1971.
- § 121-2.07 Marine insurance issued outside of Illinois.
- § 121-2.08 Industrial insured.
- § 121-2.09 Bankers' blanket bonds or directors' and officers' liability insurance issued by a captive insurance company.
- § § 121-2.10 Exempt charitable gift annuities.

### **The Industrial Insured Exemption**

The statutory definition of industrial insured in the Illinois Insurance Code contains three elements. An "industrial insured" is an insured:

(a) which procures the insurance of any risk or risks other than life and annuity contracts by use of the services of a full time employee acting as an insurance manager or buyer or the services of a regularly and continuously retained qualified insurance consultant;

(b) whose aggregate annual premiums for insurance on all risks, except for life and accident and health insurance, total at least \$100,000; and

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(c) which either (i) has at least 25 full time employees, (ii) has gross assets in excess of \$3,000,000, or (iii) has annual gross revenues in excess of \$5,000,000.<sup>2</sup>

Since its initial codification in 1937, the Illinois General Assembly has thrice amended the industrial insured provision. The latest amendment was in 1998. This latest amendment inserted "excepted for life and accident and health insurance" and substituted \$100,000 for \$50,000 in paragraph (b), and added clauses (ii) and (iii) in paragraph (c).<sup>3</sup>

What is "a regularly and continuously retained qualified insurance consultant" under subsection (a) of the industrial insured provision? Illinois, unlike some other states, does not have an insurance consultant license.<sup>4</sup> The Illinois Insurance Code requires that a person who for a fee offers advice, counsel, opinion or service with respect to the benefits, advantages or disadvantages under any policy of insurance that could be issued in Illinois, must hold an insurance producer license.<sup>5</sup> This restrictive language means that the consultant who is working with an industrial insured must have a producer license in order to be a qualified consultant. The only exceptions to the licensing mandate are Illinois licensed attorneys, limited insurance representatives, actuaries or certified public accountants working in a consulting capacity, trust officers of a bank, and licensed public adjusters performing duties incidental to their position.<sup>6</sup>

As for the "regularly and continuously retained" language, the only definition is normal usage. Aside from the industrial insured provision, the Illinois Insurance Code uses this term to describe a consultant on two other occasions,<sup>7</sup> but does not provide a definition. Even the Illinois courts have not addressed what is a regularly and continuously retained insurance consultant. Instead of defining what is a consultant, the courts favor the term "broker," especially when distinguishing between a broker and insurance agent. One Illinois appellate court described the distinction between the two as,

"We view this matter to be one essentially involving the question of agency. In insurance law it is generally accepted that an agent is one who represents a particular insurer, and a broker is one who represents an insured in the placing of insurance with a particular insurance company."<sup>8</sup>

Or as another Illinois appellate court put it,

"An insurance broker is one who procures insurance and acts as middleman between the insured and the insurer, and solicits insurance business from the public under no employment from any special company, but, having secured an order, places the insurance with the company selected by the insured, or, in the absence of any selection by him, with the company selected by such broker."<sup>9</sup>

The same court discussed insurance agents in terms of,

"Insurance agents have a fixed and permanent relation to the companies they represent and have certain duties and allegiances to such companies."<sup>10</sup>

Considering the definitions provided by the Illinois courts, the definition for broker best describes a qualified retained consultant since one of the tasks of a qualified insurance consultant is to procure insurance for an industrial insured. A necessary attribute of an insurance consultant is unfettered allegiance to the client. This is especially true in the case of an industrial insured. The industrial insured provision places the consultant on par with an employee since the industrial insured can hire an employee to perform the insurance tasks or hire a consultant. An ingredient in the employer and employee relationship is the employee's allegiance to employer.

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### **Surplus Lines Tax and Stamping Fee Liability**

Under Illinois law, only a surplus lines producer is liable for the surplus lines tax.<sup>11</sup> A surplus lines producer must file a report with the Director of Insurance on or before February 1 and August 1 for the periods from January 1 to June 30 and July 1 to December 31 respectively for the gross premium, less returned premium, on surplus lines business procured. The surplus lines tax rate is 3.5 percent on gross premium, less returned premium, and the stamping fee rate is 0.1 percent of premium.<sup>12</sup> If a surplus lines producer fails to submit the reports and pay the requisite tax, the Director of Insurance may take action against the surplus lines producer. To recover any unpaid surplus lines tax, the Director of Insurance, through the Illinois Attorney General, may institute an action to recover the unpaid tax and penalties. The surplus lines statute specifically permits charging the insured the surplus lines.<sup>13</sup>

The industrial insured statute does not mention the surplus lines tax, nor does the surplus lines statute mention industrial insured. Had the Illinois General Assembly wanted to subject industrial insured transactions to the surplus lines producer tax, it would have categorized industrial insured as a surplus lines transaction. There is nothing to indicate that the General Assembly equates industrial insured with surplus lines. Since 1937, the General Assembly has amended both the industrial insured provision and the surplus lines sections. Each time there was an opportunity to state that an industrial insured transaction involves the imposition of the surplus lines tax. Despite repeated opportunities to link the two, they remain separate and distinct insurance transactions. Therefore, an industrial insured may avoid using the services of a surplus lines producer in obtaining property insurance coverage. In such instance, since there is no surplus lines producer involved in the transaction, the industrial insured need not be concerned with the application of surplus lines tax or stamping fee to the transaction.

### **Tax Consequences in an Industrial Insured Transaction**

When a qualified insurance consultant interacts with insurers for the purpose of procuring coverage for an industrial insured, it is important for the parties involved to know that even though there is not a surplus lines producer involved, there remain other tax consequences. The industrial insured will not be responsible for the payment of these taxes; however, it is important to dispel any notion that an industrial insured transaction is a tax free transaction. The taxes discussed below for the most part are not the responsibility of the industrial insured, but instead of the insurer. However, the industrial insured will feel the impact of these taxes through the premium paid because the insured will consider these taxes when calculating the premium. Even though an industrial insured transaction is not tax free, the financial result for the industrial insured is that generally the taxes mentioned below are less onerous than the surplus lines tax, which should result in an overall reduced premium.

### **Corporate Income Tax and Personal Property Tax Replacement Income Tax<sup>14</sup>**

In Illinois, all companies earning or receiving income in Illinois must pay a 4.8 percent corporate tax on their net income.<sup>15</sup> In addition to the Illinois corporate income tax, there is also imposed a 2.5 percent personal property tax replacement income tax on a corporation's net income. If the taxpayer is a partnership, trust or Subchapter S corporation, the additional tax is equal to 1.5 percent of net income.<sup>16</sup> The taxpayer files such taxes on Form IL-1120 with the Illinois Department of Revenue.<sup>17</sup> Both the insurer and the industrial insured, unless it is an exempt organization, are subject to these taxes on net income by virtue of earning or receiving income in Illinois.

### **Retaliatory Tax<sup>18</sup>**

Foreign insurers engaged in an industrial insured transaction in Illinois are subject to a retaliatory tax if laws in such insurer's state impose more onerous or burdensome rules and regulations on Illinois insurers doing

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business in such state than would be imposed in Illinois on foreign insurers.<sup>19</sup> This tax imposes upon foreign insurers doing business in Illinois the same taxes and fees imposed upon Illinois-domiciled insurers doing business in the foreign insurer's state of domicile. The purpose of the retaliatory tax is to promote the interstate business of Illinois-domiciled insurers and to prevent other states from burdening Illinois-domiciled insurers with excessive taxes. The tax rate which the domicile of a foreign insurer charges Illinois-domiciled insurers doing business in the foreign domicile can affect the amount of income tax the foreign insurer pays in Illinois. If the foreign insurer's domicile charges less tax to Illinois-domiciled insurers doing business in the foreign jurisdiction, then in turn Illinois reduces the income tax upon the foreign insurer to the level charged in the foreign domicile.<sup>20</sup> This rate reduction for foreign insurers does not apply to insurers who are primarily reinsurers. The rate reduction is also limited. Such reduction cannot reduce the insurer's total of income and replacement taxes, privilege tax, fire insurance taxes, and fire department taxes below 1.75 percent of the net premiums subject to the privilege tax. The income tax rate reduction is determined by the insurer using a Schedule INS Tax for Foreign Insurers and attached to the Illinois income tax return.

### **Privilege Tax<sup>21</sup>**

Though the industrial insured provision makes a very strong case against paying the surplus lines tax, a company providing insurance for an industrial insured must pay the annual privilege tax. Generally the payment of the privilege tax is associated with companies licensed to do business in Illinois. However, the General Assembly, when drafting section 409 of the Insurance Code, used sweeping language that encompasses all companies. The relevant part of the section states, "every company doing any form of insurance business in this State ... shall pay, for the privilege of doing business in this State, to the Director for the State treasury a State tax equal to 0.5% of the net taxable premium written, together with any amounts due under Section 444 of this Code."

Subject to one exception, the words "every company" literally means what it states in that both licensed and surplus lines carriers are subject to paying the privilege tax. The General Assembly has not granted an exemption to section 409 for companies issuing insurance coverage to an industrial insured. A surplus lines transaction is exempt from the privilege tax since section 445 of the Insurance Code specifically exempts surplus lines from section 409.<sup>22</sup>

### **Fire Department Tax<sup>23</sup>**

This tax does not apply unless the insurer issuing a policy to an industrial insured issues a fire policy and applies only to foreign companies writing fire coverage. The municipality or fire protection district in which policies are written receives the tax proceeds. The tax is set by the municipality or fire protection district and cannot exceed 2 percent of gross receipts received from fire insurance issued on property situated in the municipality or district. The amount of fire insurance tax paid can be used to offset the privilege tax liability due.

### **State Fire Marshal Tax<sup>24</sup>**

Every fire insurance company, and any other company writing any other form of fire insurance business in Illinois, shall pay an amount not to exceed 1 percent of the gross premium less returned premiums for fire, sprinkler leakage, riot, civil commotion, explosion, and motor vehicle fire risk. A surplus lines producer must also pay this tax.<sup>25</sup> Section 445 specifically permits the surplus lines producer to charge the insured for this tax.<sup>26</sup> The revenue received from this tax is deposited in the Fire Prevention Fund.

### **Conclusion**

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In an industrial insured transaction, taxes applicable under the laws of the state of the industrial insured and applicable to such transaction will be the responsibility of the insurer, not the industrial insured. It does not follow, however, that the industrial insured will not be impacted by the application of these taxes. In the case of an industrial insured in Illinois, several taxes are involved in an industrial insured transaction. Although such taxes will not directly apply to the industrial insured, those taxes will have some impact on the industrial insured through the insurer's setting of the premium. Most notably, the absence of application of the surplus lines tax in an industrial insured transaction is a favorable tax consequence of such a transaction. Therefore, while an industrial insured transaction will not be a tax free transaction for the industrial insured, it will generally be a favored tax transaction due to the absence of the surplus lines tax, resulting in a lower premium.

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### Endnotes

1. 215 ILCS 5/121-2.
2. 15 ILCS 5/121-2.08.
3. P.A. 90-794.
4. Oklahoma, for instance, offers a consultant license and defines "insurance consultant" as an individual or legal entity who, for a fee, holds himself or herself or itself out to the public as engaged in the business of offering any advice, counsel, opinion or service with respect to the benefits, advantages, or disadvantages promised under any policy of insurance that could be issued or delivered in this state. Okla. Stat. tit. 36, § 1424.
5. 215 ILCS 5/500.15(b).
6. *Id.*
7. See 215 ILCS 5/121-2.09 and 5/123C-1.
8. *Roby v. Decatur Steel Erectors, Inc.*, 59 Ill. App. 3d 720, 725 (4<sup>th</sup> Dist. 1978).
9. *Galiher v. Spates*, 129 Ill. App. 2d 204, 206 (4<sup>th</sup> Dist. 1970).
10. *Id.* at 207.
11. 215 ILCS 5/445.
12. 215 ILCS 5/445(3), and see *Surplus Lines Association of Illinois Procedures Manual*, Chapter 8 for the stamping fee.
13. 215 ILCS 5/445(3)(c).
14. 35 ILCS 5/201.
15. *Id.* at 5/201(b)(8).
16. *Id.* at 5/201(c) and (d).

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17. Form IL-1120 Corporate Income and Replacement Tax Return.
18. 215 ILCS 5/444.
19. *Id.* at 5/444(1).
20. 35 ILCS 5/201(d-1).
21. 215 ILCS 5/409.
22. For the language granting the exception, see 215 ILCS 445(c)(12).
23. 65 ILCS 5/11-10-1.
24. 425 ILCS 25/12.
25. 215 ILCS 5/445(b) and 50 Ill. Admin. Code § 2801.130.
26. 215 ILCS 5/445(3)(c).